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C O N F I D E N T I A L SECTION 01 OF 02 BRASILIA 002237

SIPDIS

STATE PASS USTR FOR LEZNY  
NSC FOR CRONIN  
STATE PASS TO FED BOARD OF GOVERNORS FOR ROBITAILLE  
USDOC FOR 4332/ITA/MAC/WH/OLAC/JANDERSEN/ADRISCOLL/MWAR D  
USDOC FOR 3134/ITA/USCS/OIO/WH/RD/DDEVITO/DANDERSON/EOL SON  
TREASURY FOR DAS LEE AND F.PARODI

E.O. 12958: DECL: 08/18/2015

TAGS: [EFIN](#) [PGOV](#) [ECON](#) [EINV](#)

SUBJECT: BRAZIL SCANDAL: NEW ALLEGATIONS TOUCH FINANCE  
MINISTER PALOCCI AND THE MARKETS

REF: A. BRASILIA 2219  
[1](#)B. BRASILIA 2150  
[1](#)C. BRASILIA 2149

Classified By: Economic Counselor Bruce Williamson, Reasons 1.4  
(b) and  
(d).

[1](#)1. (C) Summary: Rogerio Buratti, a former advisor to Finance Minister Antonio Palocci during the latter's tenure as Mayor of the city of Ribeirao Preto (Sao Paulo State), told police during a deposition August 19 that Palocci was involved in a kickback scheme that sent Reals 50,000 per month to PT party coffers during the 2001-2002 presidential campaign. By mid-afternoon, Palocci's office had issued a categorical denial of the allegations. Palocci's statement helped reassure the markets, which made up lost ground after initial sharp reactions to the news (the Real fell almost 4% and the Sao Paulo stock exchange lost over 2% of its value when the news initially was released). Market participants told Econoff that Palocci still has significant credibility and that his statement denying the allegations would be taken seriously. One analyst argued to Econoff that, barring the emergence of convincing evidence corroborating the allegations, Brazil's current solid economic fundamentals would reassert themselves as the driving forces in the financial markets. It is clear from this episode that Palocci's tenure remains a red-line with the markets. End Summary.

#### The Allegations

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[1](#)2. (U) On August 18, former Palocci advisor Rogerio Buratti was arrested August 18 on charges that he was destroying evidence of corruption, money laundering and tax evasion. Buratti, reportedly as part of a deal to try to obtain leniency by prosecutors, agreed to testify about the schemes he was involved in. It was during this deposition that Buratti alleged that in elections from 1994 to 2002 then mayor Palocci had been involved in a kickback scheme that sent Reals \$50,000 monthly (about US\$21,000) to PT party coffers. In an August 19 press release, federal prosecutors stated that Buratti named PT Treasurer Delubio Soares as the ultimate recipient of the funds. The kickbacks allegedly were paid by a trash collection company and continued to be paid as late as 2004, through Palocci's replacement as mayor, Vice-mayor Gilberto Maggione, to Delubio Soares. It is as yet unknown whether Buratti offered any compelling evidence to back up his claims. From 1993-1994, Buratti served as Palocci's Municipal Finance Secretary. Palocci issued a statement the afternoon of August 19 categorically denying the charges.

#### Market Reaction

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[1](#)3. (SBU) The Real fell sharply (from 2.38/dollar to 2.48/dollar, a 4% drop) immediately upon release of the prosecutor's statement to the press but then recovered some lost ground, ultimately trading between Reals 2.44 and 2.48 to the dollar as of mid-afternoon August 19. Stock valuations exhibited a similar pattern, dropping over 2% when the news was released and then appreciating, with the Bovespa down 1.4% at the time of Palocci's statement. Interest rate futures on the Sao Paulo futures exchange reflected expectations of higher long term interest rates. Nilson Teixeira, chief economist at CSFB, told Econoff that Palocci's statement had helped reassure the markets.

[1](#)4. (C) BankBoston investment manager Odair Abate, speaking prior to Palocci's denial of the allegations, said the accusations had caught the markets off guard since there had not been any hint during the several months of scandal-watching that Palocci might be implicated. Arguing that Buratti was "not the most reputable" character, JP Morgan President Charles Wortman told EconOff that Palocci still had credibility in the markets and that he would have

the chance to defend himself. The markets were still working through their initial reaction to the news, and financial markets, Wortman pointed out, tend to over-correct. Wortman also noted that those players that reacted quickly and negatively to the news had been primarily local investors; foreign investors had not moved. Speaking to Econoff after Palocci's statement (and after the sharp market adjustment had halted), CSFB's Nilson Teixeira commented that there had been a market over-reaction. Like Wortman, Teixeira downplayed Buratti's credibility.

What Now?

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16. (C) All three noted that the market uncertainty could well spill over into next week should additional allegations or evidence emerge in the weekend news magazines. Abate worried that Palocci's departure, should it occur, would stretch beyond the breaking point the already thin credibility of Lula's denial of knowledge of irregular campaign financing. Assessing the probabilities of different scenarios, Abate said he now believed that it was just as likely that Lula would be forced out as it was that he would serve out the remainder of his term. Charles Wortman of JP Morgan and Nilson Teixeira of CSFB were less pessimistic, although Wortman agreed that markets "would take Palocci's departure hard." Wortman nevertheless believed Vice-Minister Murilo Portugal would be a credible replacement for Palocci. Teixeira predicted that, absent new and plausible evidence contradicting Palocci's denial of involvement, he would expect Brazil's solid fundamentals to reassert themselves with the markets in the days to come.

Comment

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17. (C) Many prosecutors and members of Congress have been using the political scandal to grandstand, but the prosecutors in the Buratti case appear to have gone overboard -- taking aim at a big target with (as yet) very little ammunition. Buratti, moreover, has some incentive to stretch the truth, if not lie outright, to strengthen his hand as he negotiates for leniency with prosecutors on evidence-tampering charges. While Buratti's credibility has yet to be established, the market's willingness to take Palocci's statement at face value speaks volumes about their faith in the Finance Minister. It also is clear from the markets' initial reaction to the allegations that the scandal has at last bumped up against one of their red lines: Palocci's tenure. His (theoretical) departure, in addition to immediate effects on the financial markets, may force the Central Bank to reconsider beginning a widely-expected cycle of interest rate cuts in the benchmark overnight interest rate (SELIC) from the current 19.75%, to try to persuade short-term foreign capital to remain in Brazil. All of which would augur ill for economic growth in the near term.

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